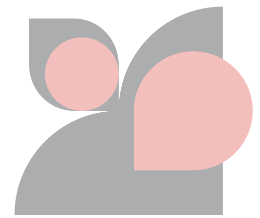

Rathbones Specialist Tax Portfolio Service (STPS)

Business relief (inheritance tax relief) mandates

Q2 2020 report

Portfolio strategy

This portfolio takes a long-term approach to investing, targeting AIM-quoted companies to qualify for relief from inheritance tax. A near-fully invested position is held throughout, and new money is invested quickly so investors reach the two-year holding threshold for tax relief as soon as possible.

The Alternative Investment Market (AIM)

AIM set out 25 years ago to provide smaller, growing companies to gain earlier and more efficient access to the public markets. Growing from 10 companies in 1995 valued at £82 million to 830 companies with a combined £97.5 billion value today proves that AIM is relevant and an international force too, accounting for 60% of all new capital raised across European 'growth' markets. In 2020 AIM raised over £2.8 billion in follow-on capital, over 30% for technology and healthcare names securing growth capital to meet the challenges and opportunities presented by the pandemic. AIM is a venue for the float of early-stage ventures - its initial ambition - and also home to 18 companies valued at over £1 billion, showing it attracts international institutional investment as well. As a benchmark for Specialist Tax Portfolio performance however, it isn't representative: AIM is too highly concentrated (2.2% of index constituents account for 34.5% of its value) and only certain AIM companies qualify for inheritance tax relief.

The Rathbones investment philosophy

Our target is profitable and established UK-based AIM-quoted companies with sustainable growth and strong competitive advantages, whether secured through acquisition or investment in innovation. These are companies we hope to be talking about for decades to come, so it's vital we have confidence in their management. Our portfolio is spread nationwide and across sectors, generating a meaningful proportion of its revenues from doing business overseas. This is a bottom-up stock selection approach that has little direct exposure to the consumer, avoiding airlines, retailers and pawnbrokers. Banks, resources, recruiters and car dealerships are excluded too.

Market commentary

The scale of COVID-19 related economic damage became clearer through the quarter, new precedents were set as governments' lockdown measures placed considerable strain on global financial systems. At home, the Office for National Statistics reported the UK economy contracted 25.1% between February and April, that's 3.5 times larger than the fall in GDP during the 2008 financial crisis.

As the global lockdown eases there are tentative signs of activity in those hardest-hit sectors, retail and construction, which support the prospect of a V-shaped economic recovery and a return to normality in 2021. Months of lockdown, limited resources plus an impending withdrawal of government support will inevitably be terminal for many businesses. Company failures have a long-lasting, butterfly effect on employment, consumer confidence and supply chains, so investors are weighing up what the extent of the damage will be, especially for labour markets and the 9.4 million furloughed jobs. A surge of mass unemployment will most hurt those economies, like the UK, that are heavily reliant on consumer spending. Worryingly, even before the pandemic there were 490,000 UK businesses in 'significant financial distress', according to business credit risk consultant Red Flag Alert. The standard 3 to 4% annual failure rate of these distressed companies is expected to soar into double-digits, leaving insolvent debt of roughly £8.6 billion in 2020, double what it was in 2019.

UK public sector borrowing in 2020 is forecast to increase by an historic 15% of GDP. Much of that increased borrowing is to plug the gap from lost tax revenues, yet a full 6.8% of GDP has been fiscal support in the shape of tax cuts, deferrals and direct spending. Despite this flood of government cash, interest rates and inflation are set to remain low for now. That's because economic demand has plummeted due to greater unemployment, while the supply of goods and services appears more than adequate for this lessened custom. This is an attractive environment for borrowers, because many bonds are yielding less than inflation, and also for shareholders, as free cash flow yields aren't being eroded by inflation.

Rathbones
Look forward

Investment manager's commentary

COVID-19 was a stress test, exposing underlying structural issues and acute health inequalities across the globe. Parallels have even been drawn with the Great Depression. One consequence of all major events is longer-term changes, a necessary and often difficult reset once weaknesses or systemic injustices are revealed. Healthcare and technology sectors should benefit from greater spending by business owners looking to compress longer-term plans into the coming months to maintain a competitive edge. Several of our portfolio holdings are well positioned to take advantage of this trend.

Abcam, the global life science tools business, has been a strong contributor to portfolio returns in 2020. It has been recognised as a crucial contributor to biological research too. Our holding Ergomed continues to perform well, as shown by better-than-expected earnings. The business helps conduct clinical trials for new drugs and cures. Ergomed's contract research business, supporting recruitment for COVID-19 trials with significant long-term potential in North America, has been identified as a strategic objective. Ceramics business Churchill China detracted from our performance. Its end markets are now cautiously emerging from lockdown, boding well for its key selling period of Q4. Meanwhile it has plenty of cash in its accounts to tide it over, which should reassure investors.

From time to time it's necessary to retire holdings when we no longer have confidence in their longer-term strategy. During the quarter we sold peripheral holdings Eco Animal Health and Accesso. Repositioning portfolios like this creates space to allocate capital to underweight or new positions. We have introduced two outstanding businesses to the fold: Codemasters and Tristel.

Codemasters develops and publishes racing video games, including Formula One, Grid, Dirt Rally, Onrush, Colin McRae Rally and Fast and Furious. The global video gaming market is expected to rake in about £160 billion this year. It's a significant and fast-growing market which is becoming part of the mainstream. Growth in China, better digital distribution and greater emphasis on mobile gaming should be supportive of Codemasters' investment case. We like the fact Codemasters has a high-quality portfolio of licensed and owned intellectual property technology, has a long-term relationship with Formula One racing, has forged relationships with all major gaming platforms and has built a loyal community of customers. Codemasters is well placed within its niche market dynamics, owns a cash-rich balance sheet and complements our tactical approach to this sector, which also includes shares in Keywords Studios and Sumo.

Tristel makes its own infection control, contamination control and hygiene products, so COVID-19 has meant that there has never been a more relevant time for its business. Tristel's' products are typically small packaged goods, requiring no after-sales service, including wipes and sprays, and their use is, for the most part, non-discretionary. This means that these consumables are written into the guidelines of medical associations. Tristel estimates that is sports a 75% UK market share in the ear, nose and throat department, and 50% of the gynaecology department. Tristel has an acquisition strategy that revolves around buying international distributors, which helps improve its profit margins. Also, it could achieve transformational growth in the US if it receives Food and Drug Administration approval over the coming years.

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